RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**
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December 9, 1977 **LETTER 716** Nov. 25, DJIA 844.42; PTI 816; A-D Ratio –19.48
Dec. 2, DJIA 823.98; PTI 812; A-D Ratio –19.60

THE MARKET: The outstanding thing about the bear market which began in September, 1976 is the unprecedented divergence between the D-J Industrial Average and the majority of NYSE issues as measured by the advance-decline ratio. In a broad sense, the Dow and the A-D ratio have diverged for the past 15 months—or ever since September, 1976. There are a number of possible interpretations of this remarkable phenomenon. One is that the A-D ratio was so shattered during 1973-74 that it is still attempting to recover from its crash low of 1974. In other words, the downside compression in the A-D ratio, brought on by the 1973-74 crash, was reversed to the upside in 1974 and the force of the upside impulse is (at least to some extent) still in effect.

Another possibility is that various negatives are now affecting the big Dow stocks, but they are affecting the medium to smaller companies to a lesser degree. For instance, it is probable that there will be **no increase** in earnings for the 30 Dow Industrials for 1978 (over 1977), yet many smaller companies may be able to boost earnings.

Next, on a *replacement cost* accounting method the earnings of many big companies look dramatically smaller than stated. For instance, on a replacement method the Dow Industrials are now selling at 23 times earnings! Furthermore, based on replacement accounting, the Dow is currently paying out dividends at the rate of 109% of earnings.

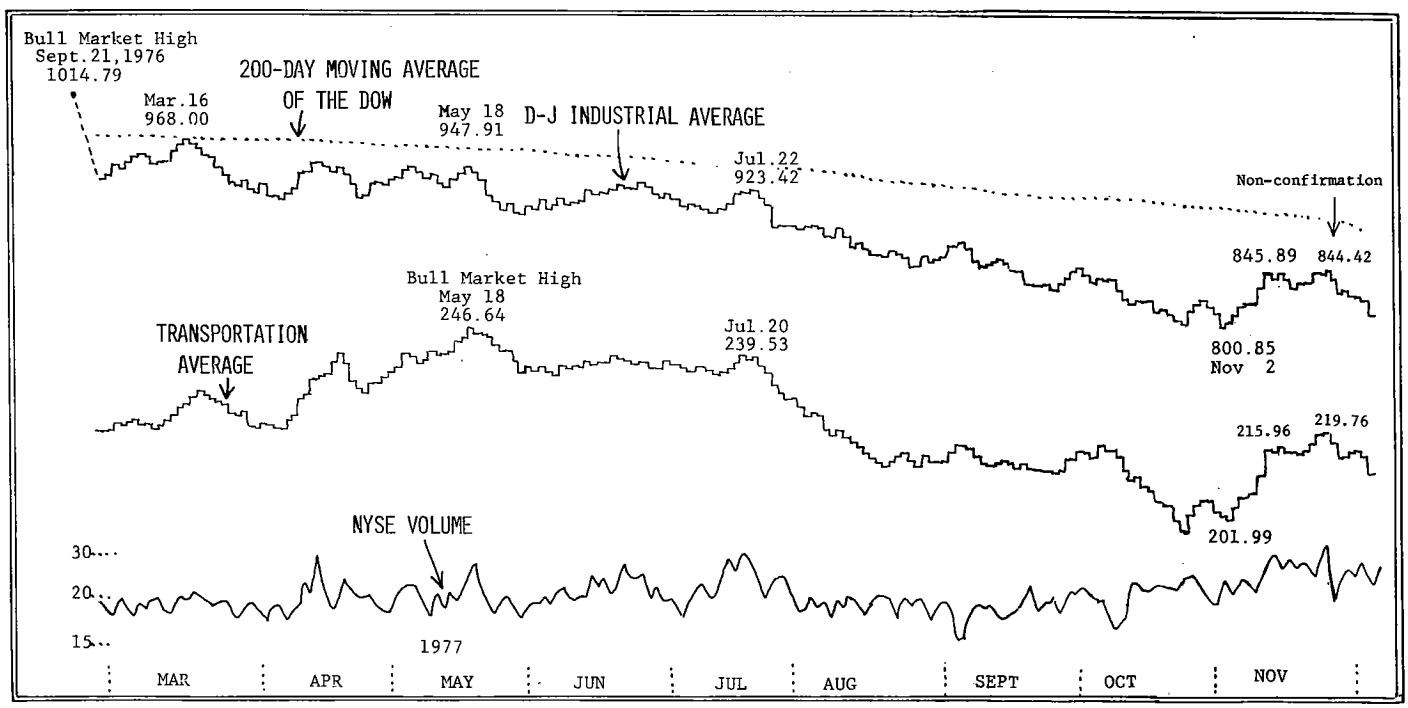
Increasing attention is now being given to **unfunded** pension liabilities for corporations. *Value Line* now lists such liabilities for each stock, and some of the figures are **shocking.** One analyst figures the pension costs for the Dow were 26.3% of 1976 earnings, and unfunded liabilities now represent 26.8% of stockholders' equity!

All of this means that the Dow stocks could be the targets of a number of Government crackdowns and pressure, pressure which I believe could spread out to the medium sized corporations—in due time.

At any rate, the performance of the A-D ratio has been strikingly better than the performance of the Dow, and this has been the case for the past 15 months. The various plausible or possible fundamentals behind this situation are all very fascinating, but *from our standpoint*, from the standpoint of the investor, it may be more profitable simply to look at the whole situation as "an interesting technical problem."

My own guess is that the Dow and the breadth are fated to get together, and that the "togetherness" will not be long in coming. From an intermediate-term standpoint, the divergence is already the longest in history, and now that almost everyone has accepted the "two-tier market" as an accomplished fact, I expect the market to revert to its one-tier or uniform way again. If that does occur, then either the breadth must drag the Dow up—or the Dow will take the breadth down. It is the second possibility that I foresee in the near future.

Turning to the Dow itself, in the last Letter I discussed the significance of the recent November 11 peak of 845.89. This was the rally peak which served to correct exactly 21% of the



entire 1976-77 Dow decline. I also discussed the 845.89 Dow peak in terms of my Fibonacci studies, and my conclusion was that the 845.89 high could be a most important one.

Next, I pointed to the *Dow Theory non-confirmation* which followed the November 11 Dow peak, a non-confirmation which saw the Transportation Average push to repeated recovery highs (see chart, page 1). The non-confirmation, I said, was particularly significant because it had occurred amid very heavy volume.

Question: Russell, what are you really saying when you talk about the 845.89 Dow peak being so important. Come on man, out with it.

Answer: I am saying that I'm skeptical about the chances of that point being bettered by the Dow. And that's another way of saying that I'm skeptical about a 1977 year end rally of any real importance. The fact is that my indicators are still on the over-bought side of the ledger, which means that any upside push from here should shortly run into resistance. Furthermore, odd lot short sales are still holding quite low (with, for instance, a shocking low 500 odd lot shorts on December 2). Finally, there is still a good deal of bullishness and speculative sentiment on Wall Street, with this year's rage, "the take-over," supplying most of the excitement. All of which makes me think that we may have seen the best part of 1977's year-end rally already.

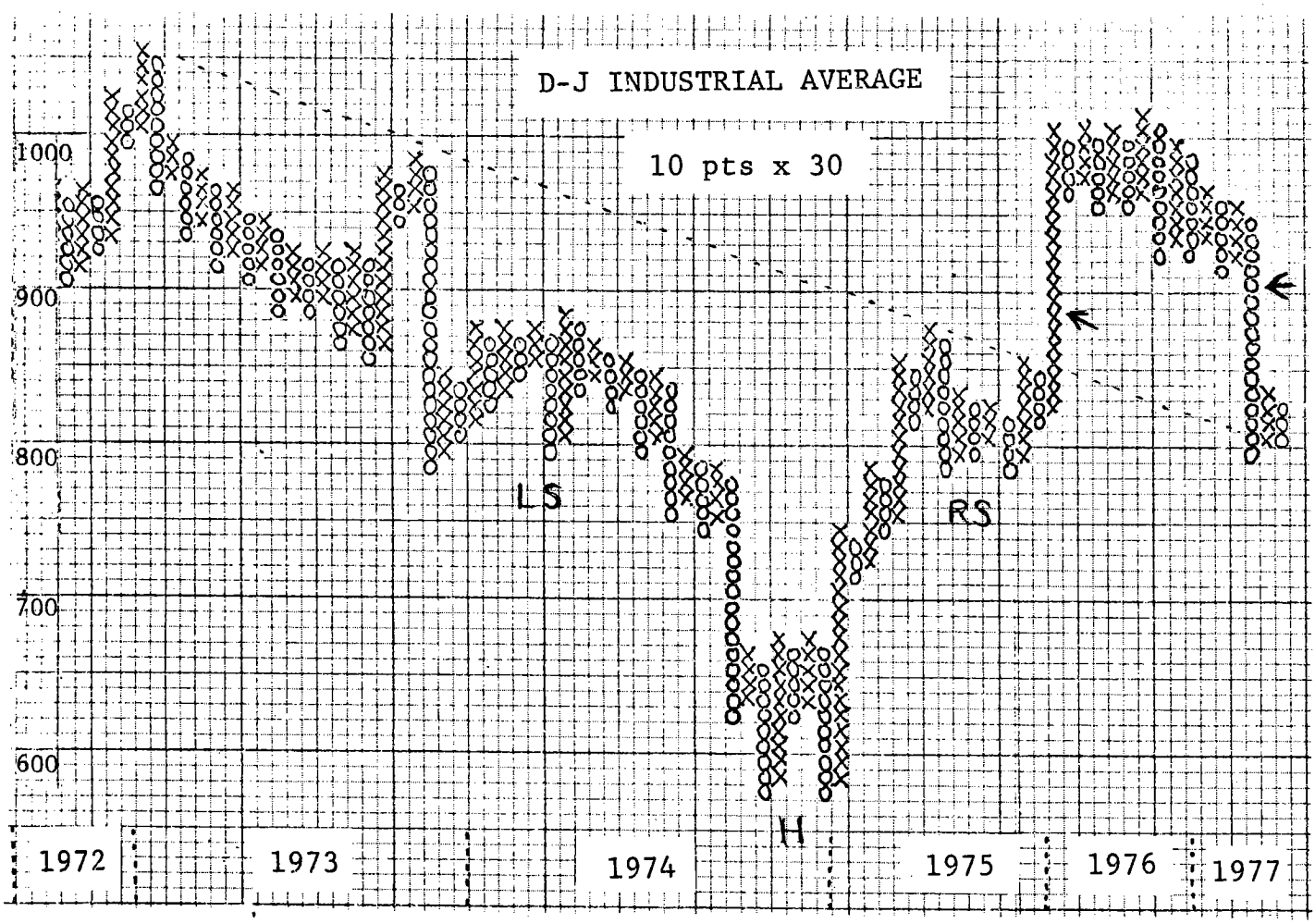
Question: All right, if you are correct, then we may at best see a see-sawing, frustrating December, 1977. But what about 1978?

Answer: If the market "pops and dribbles" and generally holds above Dow 800 in December, then I nevertheless look for an important decline during the first quarter of 1978. That decline should (hopefully) produce the long awaited over-sold situation, one that could produce an important and profitable buying area. In the meantime, I want my subscribers to refrain from trying to "beat" this market on any rally from here. Let's wait until the whole thing looks right. I believe patience can save us a lot of money over the next few months.

DOW: Over the past year I've put a great deal of emphasis on the action of the D-J Industrial Average. And I've been zero'd in on that most widely-followed of all stock Averages because I believe that the Dow has been telling the real story. Despite all the arguments, very few individuals or institutions are able to beat the Dow over any *extended* period of time. Today many people are pointing to the *short-term* superior performance of the *Value Line Composite* or the *Indicator Digest* unweighted Average, but my own experience tells me that the Dow rather accurately reflects how the average market practitioner is really doing with his funds.

I am including this point & figure chart of the Dow. It is a very *concentrated* chart, with each box representing 10 Dow points. Only Dow advances or declines of 30 points appear on the chart. This chart is known as a 10-point, 30 box reversal chart. The X's on the chart represent rallies in the Dow, while the O's depict declines.

One fascinating item on the chart is the appearance of a huge "head and shoulders bottom" during the 1974-75 period. (This



is labeled on the chart LS, H and RS). Following the "right shoulder" (RS on the chart), the Dow rallied above the critical 890 level (arrow on chart) in a major assault on the 1000 level. After pushing to the 1020 box, "something happened." It was as if a new impulse, a sudden bearish wave swept over the market.

Instead of consolidating and pushing out again, the Dow formed a distribution area during 1976 and early-1977. At the 910 box (second arrow) the entire formation broke down. The Dow sank to the recent low at 800, then rallied. All of which brings us to the present.

Two interesting items emerge regarding the decline by the Dow to the November 2 low of 800.85. The first is that the decline took the Dow just below the long term declining trendline which connects the 1972, 1973, and 1975 peaks (the trendline appears as a dotted line on the chart). Such trendlines often offer support during declines. But note also how many times previous major Dow declines were halted (at least temporarily) in the critical 790-800 area.

In November, 1971 the Dow struck an important low at 797.97. In December, 1973 the Dow decline ended at 788.31. In May, 1974 the Dow terminated its fall at 795.37. And again in October, 1975 the Dow slide halted at 784.16. Thus two technical factors combined to offer support for the Dow at the recent 800.85 low, (a) the 6-year descending trendlines, and (b) the important 790-800 level.

Will the 800.85 low of November 2, 1977 hold? My own thinking is that it will not. I believe that the Dow is now forming a right shoulder on a major head-and-shoulders **top**, a top which is becoming increasingly obvious. Therefore, I see the most recent rally (from the November 2 low) as a distribution rally which will, in due time, take the Dow below 800. The fact that the technical condition of the market at the November 2 low was unsatisfactory simply underscores my feeling about the bearishness of the situation.

INFLATE OR DIE! On December 2 the *Wall Street Journal* got the message and gave it out for all the world to read. It's a message the stock market has been sending out ever since the bull market ended on Sept. 21, 1976. It's a message I've been trying to get across to subscribers for most of this year.

The deficits and the loans and the credit extensions keep piling up. And with it all, business is "all right" but not really that great. The fact is that the whole economy is being "floated up" on a tide of inflation, with costs on an ever-rising escalator. Next year business has higher Social Security taxes to face, higher energy costs (oil, gas, electricity), higher labor costs with a higher minimum wage, probable higher pension plan costs, higher costs of imported goods (due to the sliding dollar), and possibly higher commodity costs.

The question: can all these costs be shifted over to the consumer in the form of higher prices? If they can, if the already credit-happy consumer can be enticed into taking on still more high-priced "merchandise," then we'll have more inflation in the US, and very probably double-digit inflation. But if the consumer says "No," then we'll have a recession of indeterminate severity.

What do I think? Personally, I think this year's consumer binge was a "blow off," and I think that the consumer is going to cut back in '78. Furthermore, I think we're going to see a decline in corporate profits in 1978. But here's the crux of it. The corporations never went in for capital spending after 1974. They found it cheaper and more profitable (if they wanted to expand) to "buy out the other guy" or to merge. So the basis for the "1974-77 boom" fell to the consumer. And the two pillars of the 1974-77 prosperity were *auto sales* and *housing*. Behind those two spurs lies a massive credit extension.

I think the stock market is telling us that consumers are going to "pay some of it back" during 1978, and if so, there's going to be plenty of trouble, trouble for the businessman, the consumer, for Washington, and for Mr. Carter.

I think, and this is just my own opinion, that the steadily declining dollar is telling us that US costs and US expenses and US deficits are now **out of control**. There's just no easy way off the inflation-recession dilemma any more. Foreigners see it, and they want to get out of dollars. The Dow stocks see it, and they've moving down. Interest rates see it, and they're puzzled. The Federal Reserve Board sees it, and it's confused. If the Fed moves interest rates up to protect the dollar, then the economy slumps. And if the Fed moves rates down to help business, the move is inflationary and even more bearish for the dollar.

There's no easy way of investing any more. When the basis of a nation's whole investment mechanism, its own currency, is sick, there's just no easy way. What we have to deal with now is TIMING. Our four major investment vehicles are stocks, bonds, Treasury bills, and gold. Right now my timing says T-bills with a 10% to 20% hedge in gold. Sometime over the next few months (or longer) I'm probably going to say stocks, and after that perhaps bonds. But right now it's T-bills and the gold hedge--while we wait for that major stock market low that still lies somewhere ahead.

Question: A month ago you suggested that subscribers get out of long-term bonds and municipal bonds (and out of bond funds as well). Since then bonds have pushed higher, but now they are going down again. What's next, Russell?

Answer: My advice encompassed two areas of thought. The first is that I am afraid there is far too much complacency about (a) the sliding dollar, and (b) the fantastic and continuing build-up of debt in this nation. If there is any pronounced decline in business next year (and I think there will be) we could see a rush by corporations to increase liquidity, and this could mean a lot of firms and people jamming the money markets. Such action could run interest rates way up, at least temporarily.

Uneasy Seers

More Analysts Predict New Inflation Spiral Or Recession in 1978

Social Security Tax Increase, Higher Minimum Wage To Add to Business Costs

Will Stimulus Delay Slump?

By LINDLEY H. CLARK JR.
Staff Reporter of THE WALL STREET JOURNAL

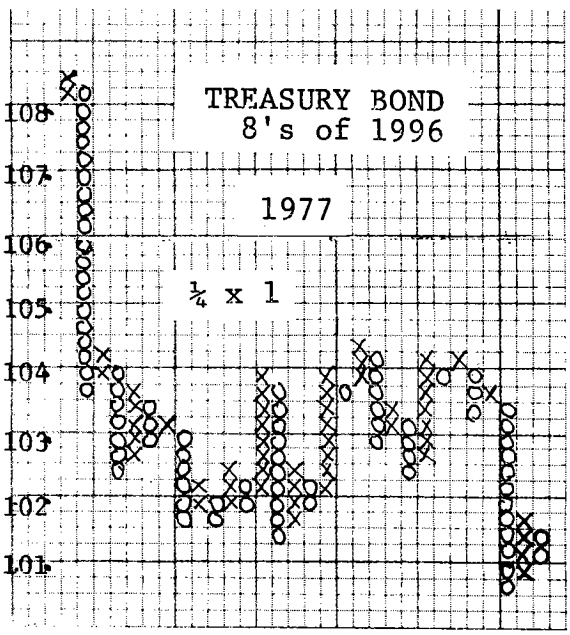
Inflation has seldom been under better control than it has been lately.

The consumer price index has gained at annual rates of less than [illegible] three months. [illegible] second

The second thing that bothers me has to do with municipal bonds. First, there is very little liquidity in that market. There are literally thousands of muni issues, and they can be hard to sell and almost impossible to sell in a rotten market.

On top of this, it bothers me that the Municipal Bond Funds have become so incredibly *popular* with the public. Can the public be that right? My data shows that the public bought $6.70 of Muni Bond funds for every $1 they redeemed in such funds during July, 1977. In August the purchase to redemption figures were 3.9 to 1. In September the public bought on a 2.4 to 1 basis. Thus, the public has been buying its head off in Muni Bond funds while redeeming very few shares. (Though the ratio is going down, it's far too high). This data bothers me. The public is just too enthusiastic about the Muni's. So let's let the public have 'em for a while.

Finally, I am including my point and figure chart of the bellwether US Treasury bond, the 8 of 1996. The chart shows every quarter point rise or fall in this bond during 1977. Following a big drop from its 108 high, this bond consolidated in the 101½ to 104 level. But the chart shows that the price structure broke down in September (long vertical row of O's) to 100 3/4. A rally occurred in October, but now the rally has faded and this bond is creeping lower. Currently it is within ½ point of its 1977 low!



I have noticed the Treasuries sliding lower, *despite the relative quiet* in the shorter-term Treasury *bill* market. And **I don't like the action**. Everyone is currently talking about "interest rates having peaked." If so, why are the Treasury 8's of 1996 moving lower? My own feeling is (1) despite the current unbelievable complacency, the US dollar is going to keep falling until the crisis makes the headlines, and (2) the Treasury bond market recognizes the danger of a lower dollar bringing on higher interest rates. The Treasuries are therefore dropping to protect themselves against trouble.

Question: What do you make of GM hitting a new low for the year on November 29?

Answer: Well, I think everyone knows what it means when the world's biggest manufacturer hits new lows. It means that the "best has been seen" for GM, and that from here on the news is going to get worse. But GM is not just your ordinary dime store stock. GM is by far the dominant figure in one of the two dominant US industries (the other one, of course, being housing). A new low in GM is bearish for the economy and for the stock market. I take the new GM low as particularly bearish, in the face of the pervasive *complacency* of today.

DIRECTION: When I was in my teens, I had an urge to be a "great artist." I'd haunt the halls of the Metropolitan Museum and go everywhere pad and pencil in hand. I signed up at the now-famous Art Student's League, and I painted myself silly. But somehow reality won. I had to face the fact that I was not fated to be another Cezanne.

In high school I decided that I was in reality a writer, and I hastened to write "the great American novel." I wrote my head off day after day, and I actually did write a novel about my high school class. But when the masterpiece was finished, I re-read it, then buried it. James Jones and Norman Mailer faced no serious threat from my career.

During the mid-1940's, after a WW II stint as an Air Force bombardier, I became increasingly interested in the stock market. I would spend long hours at the New York Public Library (in their famous Economics room) reading everything I could find on stocks and investments. Yet I couldn't seem to get my hand on anything that satisfied me, and the more I read the more frustrated I became. Finally, through luck or through elimination, I came upon the writings of the great Dow Theorist, Robert Rhea. That volume contained Rhea's advisory reports from 1932 to the day of his death in 1939. I was overwhelmed by Rhea's logic, his brilliance, his genius. Here, I decided, was a true master.

I studied Rhea's work until I believe I memorized most of it. I would take a section of the charted stock averages, fantasize how I would have acted in that situation, then read how Rhea acted, what he wrote, how he viewed the problem. I became so obsessed with this process that I think for a while I actually thought I was Robert Rhea. I spent two full years reading, re-reading and analyzing Rhea's work. My life was a haze of charts, Averages, statistics, history.

Next, I realized that I was terribly frustrated because Rhea was dead, and there was no authoritative Dow Theory report that I could read. "Why did Rhea have to die?" I anguished. And then the thought struck me, "Why not try to carry on the work Rhea had done–in the present?" I started writing a little weekly report for friends who were interested. After about six months of this, I started getting requests for the reports from people I didn't know, and at that point I began charging a mailing fee of $15 per year. That was 1957. A year later I began a series of articles for *Barron's* on the Dow Theory, and at that point my little mailings turned into a business.

Without really understanding how or why, my fascination with the stock market and my obsession with Robert Rhea's Dow Theory writing had changed the course of my life. And I'll admit it, after thirty years of following and studying the stock market, I'm still utterly fascinated with it. And I guess I always will be. One other admission–after all these years the market has never become any easier for me. Actually writing the reports has become easier, because I guess I've become a more facile writer. But the market–it's still the toughest, most frustrating, most humbling creature I know.

I often think back on my earlier dreams of being a great artist or writer. And I have to face the fact that whatever talent I have probably lies in the world of markets, not in art or literature.

It's strange how (despite our dreams and preconceived notions) we are able ultimately to find ourselves. But to do that we must–we absolutely must face the reality of ourselves. Last night I was reading a book on modern art, and I noted that the author names four men as the founding pillars of modern art. The four are Suerat, Cezanne, Gauguin, and Van Gogh. Yet what lives these great geniuses lived. Seurat died at the early age of 31. Van Gogh sold only one painting in his life, later went insane, finally shot himself. Gaugin, once a successful stock broker, deserted his family and his business and ended up painting in the South Seas, finally died in squalor–of leprosy. Only Cezanne lived a relatively normal life with the help of an income left him by his father.

So I conclude that God has a plan for each of us. Our job is to follow our "inner voice" to wherever it takes us. And if we are in tune with our inner voice, God's plan and the path of our inner voice will be one. Our reward on this earth (if we are fated to have a reward) is wisdom and the knowledge that we have fulfilled our potential.

I've given up on being a great artist. It is enough for me to read art books or appreciate what other men can do. As for my own work, my ambition is to try to be as good in market analysis as Cezanne was with his canvasses. And that, in case you don't recognize it, is a very ambitious project.

THE MORE THINGS CHANGE. . . I got a laugh out of this piece from the November 28 *New York Times*. It concerns a situation 41 years ago when the tables were reversed–the franc was weak then, and it was caving in against the dollar. But our Secretary of the Treasury in 1936 was about as knowledgeable about money as the Treasurer we have today. So this is the way the conversation ran:

> On May 1, 1936, Merle Cochran, Financial Secretary of the United States Embassy in Paris telephoned to Secretary of the Treasury Henry W. Morgenthau Jr., to let him know that French interests were selling francs and moving into dollars and sterling, and the following conversation ensued:
> Cochran: The pressure on the franc is bad.
> Morgenthau: I don't get that.
> C: I say, the franc is weak.
> M: The franc is weak?
> C: Yes, the pressure on the franc is—is heavy.
> M: I'm sorry, I don't get it.
> C: Well, the franc is weak—that I said.
> M: The what?
> C: There are many people who want to sell their francs.
> M: Yes.
> C: So it is weak as a result.
> M: I don't get that.
> C: Well, you do have it that they want to sell their francs?
> M: Yes.
> C. Well, that's the point.
> M: I see, all right.
> C: They are afraid.
> M: I see. Now—anything new on the political situation?

Question: The Dow Theory bear signal was given on November 24 when Transports finally confirmed the earlier March break of Industrials. The Dow was down 200 points by the time your Dow Theory said it was a bear signal. You got us out in May, but I'll be damned if I can see what good the Theory is or how you use it. You may be successful in your market calls–but what are you using–a dart board?

Answer: For 70 years a handful of men have been using the Dow Theory to guide them in their investing decisions and in their business decisions. The Dow Theory is not a device for beating the market, nor was it ever intended to be. I've studied the Theory for over 30 years, and I'm still learning. But how amateur market practitioners can be arrogant enough to denounce Dow's Theory is beyond me.

In all the years I've studied the market, I've watched men search for the perfect formula for market success. Most of those men are out of business and forgotten by now. I've also known men who humbly try to learn how the market works and what it is telling us. These are students like Joe Granville, Marty Zweig, Jim Dines, Tony Boeckh, Bill Bretz, Ned Davis, men who struggle with the facts and try to come up with honest conclusions (and they are usually successful).

Dow's Theory is no formula for beating the market–and **that's its strength**. The Theory requires knowledge, work, experience art and interpretation. Those who demand mechanical "buy" and "sell" signals from Dow's Theory soon leave the fold, poorer and probably just as ignorant as the day they began tangling with Wall Street.

Dow's Theory is actually *a body of knowledge* based on the price movement together with volume, market psychology, phase identification and a hundred other less obvious items. The basics of the Theory remain unchanged, but the readings change, and the situations change. I've used the Theory with pretty good results since I started this business in 1958. Over the years I've added a few things, and I've dropped a few others. But I wouldn't have a nickel of my money or my subscribers' money in the market if I couldn't use Dow's Theory. And that's the truth.

LATE NOTES & THOUGHTS: I've said that bear market rallies usually "look better" than the real thing (or true bull market advances). And the October-November bear market rally was no exception; for a while it looked like the Dow was heading for the moon. Result: a lot of traders and neophytes jumped in, and they are now trapped and waiting for the bear market to bail them out via a "year-end rally." Good luck.

I have a few thoughts that I want to get across to subscribers here. I'm afraid that the bear market from this point on is going to be very much more severe than most people expect. I think the signal for downside violence is going to be the Dow hitting 790 on an hourly basis (that would provide a major sell signal on my point & figure chart-see page 2).

Remember, over-sold market conditions are *not* brought on by the Dow declining, they are brought on by the **majority of stocks declining** (or the breadth declining). And this brings me to the second shocker. I believe we are going to see the secondary stocks, the "hold-out" stocks, the breadth of the market go down hard in 1978. Those who think they can beat this bear market by holding the secondary (non-Dow) issues are going to be looking at big losses.

Now there is a study I have which I cannot disclose to subscribers for a number of private reasons (I'm sorry). But this index is based on a large selection of NYSE issues. In the last 25 years

this study has moved to a major low (and a great buying area) every **2 to 4 years.** The last time this index hit a low was in late 1974. It has not been back to the lows since. This year, 1977, marks the 3rd year that this index has failed to produce that low. And the overwhelming odds are that the **"big low" will arrive in 1978.**

BUT–the critical part of the story is that my indicator is now very high, and that means that there is going to be *a lot of selling* between now and the major bottom I have been looking for in 1978. Actually, the fact that the breadth has been holding so well during 1977 is not, under this study, a happy development. The strong breadth of 1977 merely means that there will have to be a great deal of heavy liquidation between now and the final bottom.

What will bring on this mass of selling and this *major* bottom (it should be a bottom comparable, I feel, to 1957 or 1962 or 1970 or 1974. I think the big downside move will be brought on by liquidation of part of the huge $9 billion of margin that is currently locked into this market. And I think that a liquidity squeeze in the economy is going to be the fundamental behind the big stock market slide that I foresee.

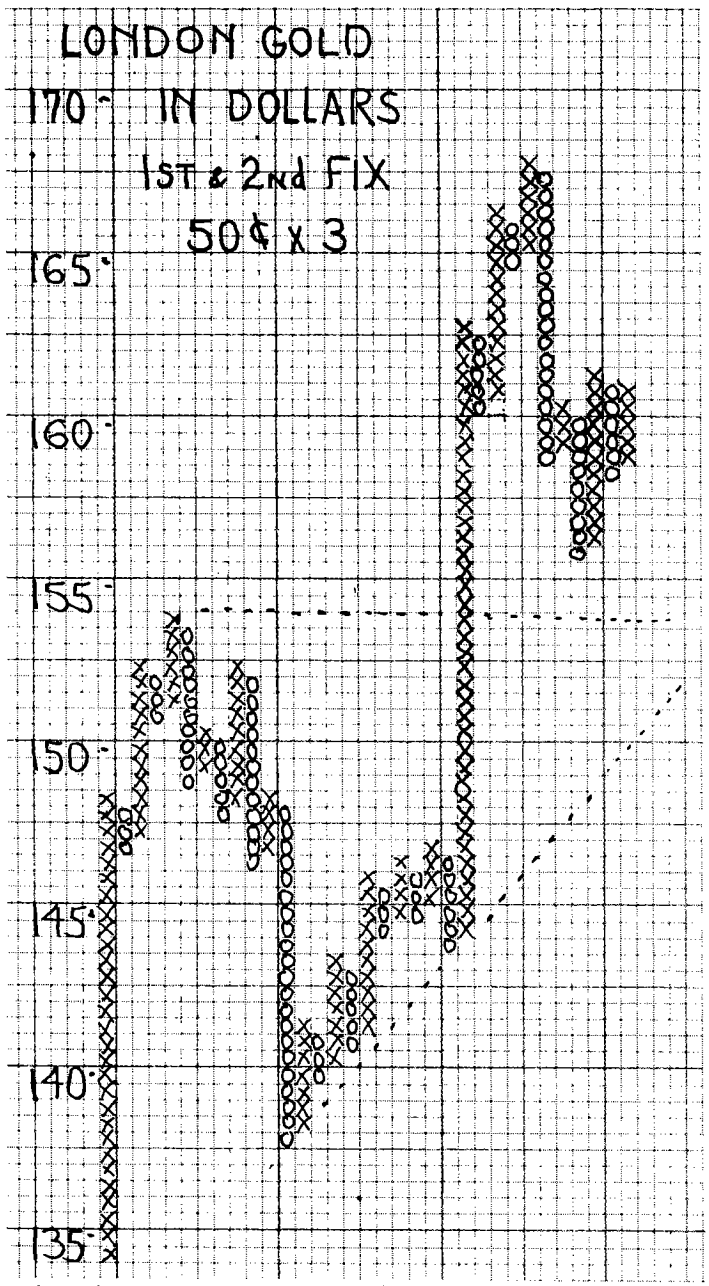
What do I want my subscribers to do? Just what I have been telling you to do all along. MOVE if you haven't yet done so, to U S Treasury bills and about 10% to 20% in gold. I don't know how rough things are going to get at the banks or at the corporate treasuries, but I suggest moving out of C/D's and commercial paper and liquid asset funds and into 91-day T-bills. Why be half or 75% or 90% safe? Let's play it safe the whole way with the T-bills and gold.

GOLD: While the Swiss franc and the German mark and the Japanese yen push to new record highs against the dollar, gold has been backing off and consolidating. I'm including here my point & figure chart of gold on a 50 cent-three point reversal chart. This means that every box represents 50 cents and only moves of $1.50 or more are shown (X's denote advances, O's depict declines). What we see here is actually just a section of the gold chart shown in the last Letter (that was a $1 X 3-box reversal chart).

Note that gold came down to 156 in a violent drop, typical of a bull market shakeout. Such moves usually knock out all the "stop loss orders" on the way down, and such drops make the price movement look as though it's heading for the basement. But the gold decline halted at 156, whereupon gold rallied to 161.50. Gold then backed off to 159, then (most recently) pushed above 160 again. The little formation pictured on the chart held well above the resistance level at 154 (horizontal dotted line on chart). An upside breakout would now come at 162 for gold. If gold hits 162 I would expect a testing of the high at 168. If gold reaches the 166-68 area, we might get a bit more backing and filling. From there on, a move above 168 would represent new highs and a completion of the correction.

On the downside, obviously a reading of 155 would indicate a new leg down for gold, in which case the 150-55 area should represent strong support. My guess is, however, that the 156 level of a few weeks ago was the bottom for this correction.

WIND-UP: *The Bank Credit Analyst's* widely-followed "Monetary Thermometer" hit plus 8 this month, thus signalling



a bearish environment for stocks (the Analyst is also bearish on bonds). Writing in the sister publication, *International Bank Credit Analyst*, Editor Tony Boeckh notes that his "world stock index" has fallen to a new 1977 low. He comments, *". . . the fact that it took an unprecedented rise in worldwide public sector budgets to achieve an under par global recovery indicates the vulnerability of the various economies to a massive debt liquidation should another contraction in economic activity get underway."*

As for the US market, the Dow is now flirting with its November 2 low of 800.85 (page 1 chart), but remember, if 800.85 is violated the Transports would have to break their 199.60 low to confirm. Obviously, I cannot tell whether or not the Averages are fated to break the 800.85 and 199.60 lows at this particular time. And I don't much care, since I'm not running on a time schedule. As far as my studies are concerned, however, any rally from above Dow 800 would merely represent distribution (while raising investors' hopes once again). Anything can happen here in December, but I feel that playing any possible or potential upside action from here is not worth the risk. Let's sit tight.

NEXT MAILING: December 21st